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Supreme Court of the United States

October Term, 1962

No. 70

IRVING J. WOLF, ROBERT H. DAVIDSON, RICHARD S. HULL and FREDERICK KATZENELL,
Petitioners,

AGAINST

ARNOLD A. WEINSTEIN, JEROME FRIED, NAZARETH FAIRGROUNDS & FARMERS' MARKET, INC., et al.,
Respondents.

—o—

IN THE MATTER

OF

NAZARETH FAIRGROUNDS & FARMERS' MARKET, INC.,
Debtor.

IN PROCEEDINGS FOR THE REORGANIZATION OF A CORPORATION, TWO CASES (No. 26362 AND No. 27000)

Brief for Respondent Nazareth Fair Grounds & Farmers' Market, Inc., Debtor and Debtor in Possession on Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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No. 27000

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Brief for Respondent Nazareth Fair Grounds & Farmers' Market, Inc., Debtor and Debtor in Possession on Writ of Certiorari to the United States Court of Appeals for the Second Circuit

CASE ONE

No. 27000

Statutes Cited

The pertinent text of the constitutional provision and statutes is set forth in Appendix B.

Questions Presented

Where there are two categories of stock claimants in a bankruptcy proceeding, to wit:

A. Investors—those who were solicited by a fraudulent promoter to invest, and paid present considerations for participation in, a specific venture, no part of which was paid for or owned in fact or in equity by said promoter;

B. Non-Investors—those who received interests in said venture from the promoter in satisfaction of, or security for his unrelated personal obligations to them, and

where the amount invested in the venture and paid to the promoter by investors was greatly in excess of the amount required for the venture, including the cost of acquisition of the subject property.

1. Did the Court of Appeals properly determine that the investors are entitled to share in the bankrupt estate in proportion to their investments, and that non-investors, who received their interests in satisfaction of the promotor's personal obligations, are not entitled to share?

2. In the allowance or disallowance of claims of stock interests in a reorganization proceeding, does a Court of Bankruptcy in the exercise of its powers have jurisdiction to ascertain and enforce the equities of parties before it and apply its own equitable principles according to the circumstances of the particular case? The corollary to this is the proposition whether the bankrupty court in the distribution of property in its possession has full jurisdiction to determine the rights of parties in and to that property.

Statement of the Case

The Debtor operates a farmers' market and shopping center in Nazareth, Pa. The events leading up to the acquisition of the market and the dealings relating to participations therein are hereinafter set forth. The function and role of one John Malakoff, as the promoter or syndicator of the Nazareth venture which became the Debtor, is of prime importance.

Murray Realty Co. was a Pennsylvania partnership composed of Edward Malakoff and Murray Malakoff. Zoloth and Soble were joint venturers or dummies in certain of the real estate transactions in which Murray engaged [R. 230-1, 286-7].

To avoid personal liability, Murray would take title to real property in the name of Richard Realty Co. or Kipling Realty Co., Pennsylvania corporations, the stock of which was wholly owned by Murray [R. 282-3]. These persons or entities are sometimes referred to as the Philadelphia Group.

On April 17, 1951, Richard Realty Co. closed title and purchased the realty and business now owned by the Debtor from Nazareth Fairgrounds, Inc., a corporation unrelated to the Debtor. The title closing statement [R. 531] shows the purchase price to have been $66,000, subject to two mortgages totalling $18,500.* The actual cash payment required of Richard Realty was $47,500. It was this cash amount which was involved when John Malakoff purchased the business and property in the manner hereinafter set forth.

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*On May 14, 1951, Richard conveyed the business and realty to Kipling Realty Co. (a dummy corporation) subject to the two mortgages [R. 230-31]. On September 26, 1951, Kipling conveyed to the Debtor [R. 231].

The purchase transaction was reflected in the journal of Murray Realty Co. [R. 537]. The journal reflects the payment of $42,732.99 to Commercial Title Co. in accordance with the closing statement. Disregarding some minor entries which are immaterial, the $5,000. (reflected on the closing statement as having been paid on account) appears in the journal under date of May 7, 1951 as having been paid by E. Malakoff.

In April of 1951 when the Philadelphia Group first acquired the Nazareth property, John Malakoff and Edward Malakoff, his nephew and head of the Philadelphia Group, met with claimant, Kanter, and others. Edward Malakoff proposed to them that they buy one-fourth of the Nazareth market for $16,000. Kanter and the others agreed to do so and advanced the necessary funds. None of John Malakoff's money was used to pay the purchase price. His interest was contingent. He was to receive a share of the profits in the event of a sale [R. 306-7]. John Malakoff's record book showed his interest as "one-third of profit to office" [Saul, General: Debtor's Ex. K—R. 547].

Edward Malakoff denied any arrangement to sell a one-fourth interest in the market. Instead, he described an oral agreement of July 1951 whereby John Malakoff agreed to purchase the Nazareth business and real estate at the price paid for it by the Philadelphia Group, namely, $47,500. (cash) plus $30,000., plus $2,800. which covered miscellaneous items [R. 283].

The Philadelphia Group organized the Debtor on or about August 1st, 1951. Its office was designated as Room 603, 1660 Walnut Street, Philadelphia which was the office of Murray Realty Co. [R. 53]. The Debtor was authorized to issue 200 shares of no par value stock with a stated capital applicable thereto of $120,000.

On August 8, 1951, Debtor's stock certificate No. 1 was issued to Zoloth and Certificate No. 2 was issued to Soble, each certificate being for ten shares.

On October 17, 1951, Zoloth and Soble assigned their 20 shares of stock to John Malakoff pursuant to a contract of sale [Saul, General: Debtor's Ex. F—R. 540-41]. The price was $32,853.08 payable in installments and the contract provided that the certificates were to be held in escrow by the sellers who retained the voting rights until payment was made.

Simultaneously with the formation and incorporation of the Debtor, the Philadelphia Group converted their capital contributions in the Nazareth venture to loan accounts. Thus, Soble's books were adjusted to transfer John Malakoff's capital account of $17,489.00 * to a loan account; similarly, Soble's capital account of $40,000 was transferred to a loan account of $37,000, and, after minor adjustments, the balance of $1,500 remaining as capital of Zoloth [Saul, General: Examiner's Ex. BU—R. 507].

The next step was to transfer these capital and loan accounts on the books of the Debtor. This was done [R. 439-40]. Originally, the loans were capital investment. No money was actually put in at the time of the loan entries—they were mere book entries [R. 433-4].

The procedures used by the Philadelphia Group and Malakoff constituted a design whereby public investors were to be bilked.

During the course of the foregoing transactions, John Malakoff solicited and received funds from claimants who gave him their money for the express purpose of investing

* This was not Malakoff's money. It was supplied by investors specifically for Nazareth.

in Nazareth. Appendix 'A' is a schedule showing the amounts of money received by Malakoff from Nazareth investors and the amounts he, in turn, paid to the Philadelphia Group. At all times, Malakoff received more from the investors in Nazareth than he paid out:

A. Up to February 15, 1952 (the date of the last payment to the Philadelphia Group) Malakoff received a total of $88,025. for investment in Nazareth;

B. Up to February 15, 1952, Malakoff paid $49,489 to the Philadelphia Group. He also paid $9,507.00 for improvements to the Nazareth property. In all, Malakoff paid out $58,996;

C. Up to February 15, 1952, Malakoff received $29,029. more from the investors than he paid to the Philadelphia Group and for improvements;

D. After February 15, 1952, Malakoff received an additional $72,337. for investment in Nazareth;

E. After February 15, 1952, there were no further payments to the Philadelphia Group;

F. All told, Malakoff received $160,362. and paid out $58,996., the excess of his receipts over payments amounting to $101,366.

Malakoff assumed control of the Debtor before October, 1951. No corporate meetings were held. The minutes reflected in the minute book were back dated [=32—R. 56].

With some exceptions, investors paid $1000.00 per share or participation based on 200 shares to be issued and a representation that dividends of 20% annually would be

paid on the amount invested [=127—R. 204]. The Nazareth project was a joint venture [=38—R. 208]. At the outset, title was in the Debtor corporation but subject to change in the future to a limited partnership [R. 187]. All checks given for investment in Nazareth were drawn to John Malakoff or his agent and were endorsed "John Malakoff, agent" or "John Malakoff, special". All cash given for investment was delivered to Malakoff.

So-called dividend payments made by Malakoff during the course of his promotion were in fact a return of capital to the recipients. No dividends were ever declared by the Debtor. It had no profits or surplus out of which any dividends could be declared.

Beginning in February, 1953 and thereafter, Malakoff issued stock certificates to the investors and also issued stock certificates in satisfaction of, or as security for, his personal obligations. In all, 316 shares were issued despite authorization for only 200.

Late in May or June of 1953, Malakoff caused the preparation of a set of predated minutes which purported to have all of the Debtor's stock issued to him. The Court of Appeals has found these minutes to be fraudulent [R. 592].*

In June, 1953, Malakoff's fraudulent promotion came to an end. On June 17, 1953, he assigned stock certificates No. 1 and No. 2 to the Debtor by endorsement [=37—R. 57]. He also released the so-called loan accounts owing to him on the books of the Debtor and described the same as having been owed to him for services rendered [R. 554-6].

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* These were not the only Nazareth minutes found to be fraudulent *Margolis* v. *Nazareth Fairgrounds & Farmers Market, Inc.*, Debtor, 240 F. 2d 221 (1957).

The end of the promotion found the Debtor in difficulty with respect to the ownership of its shares of stock. The Debtor was insolvent in the bankruptcy sense [Bankruptcy Act, Section 1(19)] and under Chapter 10 of the Act [Section 130(1)] from the time of its incorporation to the time of the filing of the petition. On August 8, 1951, current liabilities exceeded current assets with net worth of only $1,500 [R. 513]. On June 30, 1952, liabilities exceeded assets [R. 514]. At June 30, 1953, judgment notes for $13,600, which were unreflected on the balance sheet for that date, resulted in current liabilities greater than current assets [R. 518; judgments vacated in 1957—*Margolis v. Nazareth Fairgrounds & Farmers Market, Inc.*, 249 F. 2d 221]. The Debtor was also insolvent under the laws of Pennsylvania.* Shortly before the petition was filed, the Debtor could not pay its bills as they matured [R. 400].

On September 28, 1953, a petition for reorganization under Chapter X of the Bankruptcy Act was submitted to the U. S. District Court for the Southern District of New York and the process of reorganization has been going on since that time.

Summary of Argument

A court of bankruptcy is a court of equity and, in allowing and disallowing claims and distributing the assets of the bankrupt estate, it is empowered to apply its own equitable principles. Its application of state law is discretionary. In any case, petitioners have not cited any controlling state equitable principles which are properly applicable here. Whatever state authorities do exist

* *Fidelity Trust Co. v. Union National Bank of Pittsburgh*, 315 Pa. 467, 480.

are not in conflict with the equitable principles applied by the Court of Appeals below.

John Malakoff did not own any interest in the Nazareth venture. He made no contribution to the venture. He was a fraudulent promoter who solicited funds of others for investment. In the process, he collected $160,362. from the investors and paid out of these funds only $58,996. for venture purposes [Appendix A]. Additionally, he satisfied his personal obligations to the extent of more than $62,000. by giving out shares of Nazareth to his creditors. This was done at a time when the Debtor was insolvent.

Malakoff and the Philadelphia Group deceitfully conceived, created and used the debtor corporation to effectuate a fraud on the Debtor's existing and future creditors and stockholders. This was done through the use of a fictitious loan account and other fraudulent devices, all of which rendered Debtor insolvent.

Despite these frauds, petitioners contend that the initial 20 shares of stock issued by the Debtor and held by Malakoff, as well as a loan account on Debtor's books in his name, are valid and that Malakoff was thereby the owner of all the Debtor's stock, both issued and unissued. Thus, petitioners' claims are predicated on muniments of title fraudulently acquired by Malakoff.

In the light of the frauds practiced, and because the Debtor corporation was merely a transitory vehicle for the Nazareth venture, equity dictates that its corporate veil be pierced and a trust impressed on its assets for the benefit of the investors in proportion to the contributions they actually made to the venture. The Debtor, which was the *alter ego* of Malakoff [=133 B. 206], was fraudulently created in violation of Malakoff's

fiduciary obligations to the investors. A court of equity should, therefore, look to the substance of the transaction by disregarding the corporate entity.

Petitioners submit their arguments based on the application of strict corporate law. This would work an inequitable result. Moreover, the corporate law cited by petitioners does not apply here.

Only the investors who contributed specifically to the Nazareth venture are entitled to share in the distribution of the assets of the bankrupt estate. Claimants who received their interests in the venture in satisfaction of the promoter's personal obligations, and who therefore contributed nothing to the venture, are not entitled to share in the distribution of the bankrupt estate.

POINT I

A Bankruptcy Court is a Court of equity and in the exercise of its powers has jurisdiction to ascertain and enforce the equities of parties before it and apply its own equitable principles according to the circumstance of the particular case. As a corollary to this is the proposition that the Bankruptcy Court in the distribution of property in its possession has full jurisdiction to determine the rights of parties in and to that property.

The petitioners have raised the issue of the scope and extent of the powers of a Court of Bankruptcy. They question the Court's right to apply its own equitable substantive law and principles. They maintain that a Federal Court, in the instance of bankruptcy, must apply the state law of the forum. It is necessary, therefore, to trace the development of the powers of Courts of Bankruptcy under the Congressional enabling statutes which

put Article 1, Section 8, Clause four of the United States Constitution into effect, and to the decisions of this Court which have discussed, interpreted and amplified the extent of the equitable powers of a Court of Bankruptcy.

Article 1, Section 8, Clause four of the Constitution of the United States gives to Congress the power "To establish * * * uniform Laws on the subject of Bankruptcies throughout the United States;"

Our original thirteen states were, of course, former English Colonies. They brought England's bankruptcy laws with them as they did the Common Law upon which our legal institutions are based.

There was no uniform pattern followed by the states in the regulation of commercial transactions and of insolvencies. This impeded interstate commercial practice.

In England, bankruptcy laws were enacted as an adjunct and aid to their laws governing commerce.

Madison commented at that time:

> "The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce and will prevent so many frauds where the parties or their property may lie or be removed into the different states, that the expediency of it seems not likely to be drawn into question." The Federalist No. 42; and see Senate Doc. No. 65, 72nd Congress, 1st sess. (1932) 50.

Charles Pickney, author of the first draft of the bankruptcy clause and his fellow delegates who attended the Constitutional Convention, did not however include the bankruptcy provision in Clause Three which was partly

restrictive and related to Commerce. Instead, Article I, Section 8, Clause four of the Constitution was enacted. These circumstances, and a reading of Article I, Section 8, *supra*, clearly supports an inference that it was the intention of the draftsmen to give Congress the all inclusive power to legislate and implement on all issues involving the subject of bankruptcies.

It is beyond question that the granting of the all inclusive power of legislation in bankruptcies necessitates the all inclusive power of implementation thereof, otherwise the result would be a nullity.

The following provisions of the Bankruptcy Act were enacted by Congress which affect the issue which is before the Court: (The text of these statutes is to be found in Appendix B.)

Section 2 of the Bankruptcy Act, 11 U. S. C. §11; Section 67b of the Bankruptcy Act, 11 U. S. C. §107b; Section 67c of the Bankruptcy Act, 11 U. S. C. §107c; Section 67f of the Bankruptcy Act, 11 U. S. C. §107f; Section 70a of the Bankruptcy Act, 11 U. S. C. §110a; Section 70c of the Bankruptcy Act, 11 U. S. C. §110c; Chapter X, Section 111 of the Bankruptcy Act, 11 U. S. C. §511. Chapter X, Section 112 of the Bankruptcy Act, 11 U. S. C. §512; and Chapter X, Section 196 of the Bankruptcy Act, 11 U. S. C. §596.*

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* §196 of the Bankruptcy Act gives the bankruptcy court power to determine "the interests of stockholders" Petitioners do not claim that Chapter X is unconstitutional, nor could they in view of *Continental Bank* v. *Rock Island Railway* (1935) 294 U. S. 648. As stated in Collier on Bankruptcy (14 Ed.) Vol. 6, p. 95:

> "A corporate reorganization statute represents an exercise of the power conferred on Congress by Article 1, §8, Clause 4 of the Constitution, 'to establish * * * uniform laws on the subject of bankruptcies throughout the United States'. The charge that such a statute is not within the 'subject of bankruptcies' has been refuted many times by the courts."

These sections, of course, are only several of the sections affecting the question before this Court but will suffice, since they are amply illustrative for the purpose of the discussions.

The question to be answered therefore is:

> "Does a Court of Bankruptcy within the purport and spirit of the Bankruptcy Act when dealing with the allowance, disallowance and subordination of claims, and the distribution of a bankrupt's estate, have the power to apply its own equitable principles and implement the decision?"

It is to be noted that under Section 2b of the Bankruptcy Act, 11 U. S. C. §11b, *the purport of the Act was to give bankruptcy courts inherent and general powers that a Court of equity has which have not been specifically enumerated.* This provision obviously was not intended to restrict the powers of a bankruptcy court as a court of equity, but rather, was obviously intended to grant such Court the broadest possible equity powers.

Under Section 67b of the Bankruptcy Act, 11 U. S. C. §107b, Congress specifically provided which laws of a state (statutory lien laws) should be binding, showing an intention under the Bankruptcy Act to provide specifically when a Federal Court must recognize State law. Thereafter, by sections 67c(1) and (2), 11 U. S. C. §107c (1) and (2), even that recognition was restricted. If Congress intended that a Federal Court of Bankruptcy must apply state law in all instances, then Section 67b, *supra*, would be superfluous and unnecessary because that principle would be all embracing.

The Rules of Decisions Act (28 U. S. C., Sec. 1652; 62 Stat. 1652), upon which petitioners rely as authority for

the application of state laws here, does not apply in bankruptcy. The Act contains an express proviso that the laws of the several states apply "except where the Constitution * * * or Acts of Congress otherwise require or provide." Proceedings in Bankruptcy fit within the exception. Congress has enacted the Bankruptcy Act pursuant to the Constitutional grant of power to enact uniform bankruptcy laws. *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 240 (1934).

The general proposition that a Bankruptcy Court is a Court of equity is well established. In the exercise of its powers as such, it has the jurisdiction to ascertain and enforce the equities of parties before it. Corollary to this is a proposition that the Bankruptcy Court in the distribution of property in its possession, has full jurisdiction to determine the rights of parties in and to that property.

Subsection (7) of 2 of the Bankruptcy Act of 1898, as amended, provides that courts of bankruptcy are invested with such jurisdiction at law and in equity as will enable them to "cause the assets of bankrupts to be collected, reduced to money and distributed, and determine controversies in relation thereto, except as herein otherwise provided."

The trend to retain and exercise exclusive powers in bankruptcy in the Federal Courts was enunciated in the early case of *Sturges* v. *Crowninshield*, 4 Wheat. 122 (1819). Chief Justice Marshall declared that the power to legislate in the bankruptcy field was available to the states unless and until the Federal Government exercised the power.

"It is not the mere existence of the power, but its exercise, which is incompatible with the exercise of

> the same power by the States. It is not the right to establish these uniform laws, but their actual establishment, which is inconsistent with the partial acts of the States."

In examining the history of this doctrine, it is well to remember that during the greater part of the history of our country there was no federal bankruptcy law in effect. The states themselves, however, generally made use of their legislative powers in this field during the first one hundred years of our existence as a republic. The sporadic exercise of the federal bankruptcy powers in the periods from 1800 to 1803, 1841 to 1843, 1867 to 1878, and then from 1898 to the present day gave rise to litigation involving the question of the suspension of state law by reason of the enactment and operation of these federal bankruptcy acts. From these cases, the doctrine has come to be well settled "that state insolvency laws which are tantamount to bankruptcy because they provide for an administration of the debtor's assets and a winding up of his affairs similar to that provided by the national act are suspended while the latter remains in force, and proceedings under them are utterly null and void whether commenced within four months of the filing of a petition in bankruptcy or before. *Straton* v. *New*, 283 U. S. 318, 327 (1931).

Hollins v. *Brierfield Coal & Iron Co.*, 150 U. S. 371 (1893) was a forerunner of the cases involving bankruptcy principles and the powers of a bankruptcy Court.

The Court held (p. 379):

> "The line of demarcation between equitable and legal remedies in the Federal Courts cannot be obliterated by state legislation."

and on page 382:

> "When a corporation becomes insolvent, it is so far civilly dead that its property may be administered as a trust fund for the benefit of its stockholders and creditors. A court of equity, at the instance of the proper parties, will then make those funds trust funds, which, in other circumstances, are as much the absolute property of the corporation as any man's property is his."

Scott v. *Neely*, 140 U. S. 106 (1891) held: The general proposition that new equitable rights created by the States may be enforced in the Federal Court is correct but it is subject to the qualification that such enforcement does not impair any right conferred, or conflict with any prohibition imposed by the Constitution or Laws of the United States.

In *Bardes* v. *Hawarden Bank*, 178 U. S. 524 (1900), it was held that proceedings in bankruptcy being in the nature of proceedings in equity, frequently call for the exercise of the full equity powers of the Court in the ascertainment and proper enforcement of the equities of the parties, and that where this is so a court may apply equitable rules and will be governed by equitable principles. This case was followed shortly by the case of *Mueller* v. *Nugent*, 184 U. S. 1 (1902) holding that the filing of the petition in bankruptcy is in effect an attachment and upon adjudication the title vests in the trustee and the custody of the property vests in the bankruptcy court.

Thhereafter, in the case of *Whitney* v. *Wenman*, 198 U. S. 539, 552 (1905), it was held that by virtue of the powers granted under subsection (7) of Section 2 of the Bankruptcy Act, there is vested in the bankruptcy court com-

plete jurisdiction to determine controversies in relation to the property in the court's control, and to proceed to a complete determination of a matter of controversy.

In *Kothe Trustee* v. *R. C. Taylor Trust*, 280 U. S. 224 (1930), this Court did not apply state law and held at page 227,

> "The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate among creditors holding just demands based upon adequate considerations."

Since the decision in *Kothe Trustee* v. *R. C. Taylor Trust*, there have been a number of decisions both in the Supreme Court and in other federal courts holding that where a court of bankruptcy has once assumed control of the bankrupt's property, it has exclusive jurisdiction to determine all questions affecting that property. *Isaac* v. *Hobbs Tie & Timber Co.*, 282 U. S. 734 (1931); *Gross* v. *Irving Trust Co.*, 289 U. S. 342 (1931); *Taylor* v. *Sternberg*, 293 U. S. 470 (1935).

The case of *Local Loan Co.* v. *Hunt*, 292 U. S. 234 (1934) is particularly significant. There the Court held at page 240:

> "* * * courts of bankruptcy are essentially courts of equity and their proceedings inherently proceedings in equity * * *."

at page 244:

> "We find it unnecessary to consider whether this contention would in a different case find support in §34 of the Judiciary Act of 1789, now §725, Title 28, U. S. C. since we are of opinion that it is precluded here by the clear and unmistakable policy

> of the bankruptcy act. It is important to bear in mind that the present case is one not within the jurisdiction of a state court, but is a dependent suit brought to vindicate decrees of a federal court of bankruptcy entered in the exercise of a jurisdiction essentially federal and exclusive in character. And it is that situation to which we address ourselves, and to which our decision is confined."

It is significant that the Bankruptcy Court is created under the authority of the Constitution and in allowing, disallowing or subordinating claims is acting under a Congressional Act.

The case of *Kuehner* v. *Irving Trust Co.*, 299 U. S. 450 (1936), was a 77B Reorganization case and involved a claim of bankruptcy for damages for breach of contract under a lease between the bankrupt and the claimant.

The claimant raised the issue that the bankruptcy act as applied to him exceeded the legislative powers granted and infringed upon personal *guarantees* given by the Constitution, and that the resulting violations of the Constitution were transgressions of the boundaries of the bankruptcy power vested in Congress and the taking of their property without due process.

The Court held that the equitable distribution of a bankrupt's assets or the equitable adjustment of creditors' claims in respect to their assets by way of reorganization may thereafter be regulated by a bankruptcy law which impairs the obligations of the debtor's contracts. *Indeed, every bankruptcy act avowedly works such impairment.*

A non bankruptcy case *Erie R. Co.* v. *Tompkins*, 304 U. S. 64 (1938) appeared on the horizon and seemed to becloud the issue and the trend until *Pepper* v. *Litton*, 308 U. S. 295 (1939), a bankruptcy case, was decided by

this Court one year later. This court reinstated the trend and vigorously supported the equity powers of a bankruptcy court in the allowance, disallowance or subordination of claims in a bankruptcy case.

The *Erie* case involved a tort action and this court held that in a non-diversity case *except in matters governed by the Federal Constitution or by Acts of Congress* the law to be applied in any case is the law of the State and that there is no Federal, general common law.

In *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307 (1939), this Court again decided that the power of the Bankruptcy Court to subordinate or to adjudicate the equities between the several creditors is complete.

The *Erie* case was then distinguished and held inapplicable to bankruptcy cases by *Pepper* v. *Litton*, 308 U. S. 295 (1939) which involved a bankruptcy proceeding. The Court stated at page 303:

> "Courts of bankruptcy are constituted by 1 and 2 of the Bankruptcy Act (30 Sat 544) and by the latter section are invested 'with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings. Consequently, this Court has held that for many purposes 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity' *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 240. By virtue of 2 a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the Act, it applies the principles and rules of equity jurisprudence. *Larson* v. *First State Bank*, 21 F. 2d 936, 938. Among the granted powers are the allowance and disallowance of

> claims; the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto; the rejection in whole or in part—'according to the equities of the case' of claims previously allowed, and the entering of such judgments 'as may be necessary for the enforcement of the provisions' of the Act. In such respects the jurisdiction of the bankruptcy court is exclusive of all other courts. *United States Fidelity & Guaranty Co.* v. *Bray*, 225 U. S. 205, 217."

Sampsell v. *Imperial Paper & Color Corp.*, 313 U. S. 215, 219 (1941), decided by this Court reiterated the principle laid down in the *Standard Gas* case, *supra*, and held that,

> "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete."

This was followed by *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89 in 1942 where this Court held that nothing decided in *Erie R. Co.* v. *Tompkins* requires a court of bankruptcy to apply a local rule governing the liquidation of insolvent estates. The bankruptcy act prescribes its own criteria for distribution to creditors.

In *American Surety Co.* v. *Sampsell* (1946), 327 U. S. 269, the Court said at page 272:

> "We recently had occasion to reiterate that federal bankruptcy law, not state law, governs the distribution of a bankrupt's assets to his creditors. *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89, 95. See also *Pepper* v. *Litton*, 308 U. S. 295, 303-306; *Prudence Realization Corp* v. *Ferris*, 323 U. S.

650, 653. True, we stated in both *Prudence* opinions that the federal law governing distribution of a bankrupt's estate should be applied with 'appropriate regard for rights acquired under rules of state law * * *.' *But the extent to which state law is to be so considered is in the last analysis a matter of federal law.*" (Emphasis added.)

Heiser v. *Woodruff*, 327 U. S. 726 (1946) is important in the line of cases which clarified the powers of a bankruptcy court. This court stated at page 731:

> "We need not consider whether, apart from the requirements of the full faith and credit clause of the Constitution, the rule of *res judicata* applied in the federal courts, in diversity of citizenship cases, under the doctrine of *Erie R. Co.* v. *Tompkins*, 304 U. S. 64; cf. *Guaranty Trust Co.* v. *York*, 326 U. S. 99; *Holmberg* v. *Armbrecht*, 327 U. S. 392, can be other than that of the state in which the federal court sits. For nothing decided in *Erie R. Co.* v. *Tompkins*, *supra*, requires a court of bankruptcy, in applying the statutes of the United States governing the liquidation of bankrupts' estates, to adopt local rules of law in determining what claims are payable, or to be allowed, or how the bankrupt's estate is to be distributed among claimants. Cf. *Board of Comm'rs* v. *United States*, 308 U. S. 343; *Deitrick* v. *Greaney*, 309 U. S. 190; *D'Oench, Duhme & Co.* v. *F. D. I. C.*, 315 U. S. 447; *Helvering* v. *Stuart*, 317 U. S. 154, 161-2; *Sola Electric Co.* v. *Jefferson Co.*, 317 U. S. 173, 176; *Wraaq* v. *Federal Land Bank*, 317 U. S. 325, 328; *Clearfield Trust Co.* v. *United States*, 318 U. S. 363."

Vanston Committee v. *Green*, 329 U. S. 156 (1946) is a landmark case in establishing this court's recognition of the difference between *Erie* v. *Tompkins*, *supra*, and a bankruptcy case in applying state law or Federal law whether statutory or by court decision. The Court stated at pages 162 and 163:

> "In determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits. *Erie R. R.* v. *Tompkins*, 304 U. S. 64, has no such implication. That case decided that a federal district court acquiring jurisdiction because of diversity of citizenship should adjudicate controversies as if it were only another state court. See *Holmberg* v. *Armbrecht*, 327 U. S. 392. But bankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles."

In *Gardner* v. *New Jersey*, 329 U. S. 565, 573 (1947) (a bankruptcy reorganization case), a state claimed that by its state created statute it had a claim which had to be recognized. The court held:

> "• • • Without that sifting process, unmeritorious or excessive claims might dilute the participation of the legitimate claimants.
>
> "It is traditional bankruptcy law that he who invokes the aid of the bankruptcy court by offering a proof of claim and demanding its allowance must abide the consequences of that procedure. *Wiswall* v. *Campbell*, 93 U. S. 347, 351. If the claimant is a State, the procedure of proof and allowance is not transmuted into a suit against the

> State because the Court entertains objections to the claim. The State is seeking something from the debtor. No judgment is sought against the State. The whole process of proof, allowance and distribution is, shortly speaking, an adjudication of interests claimed in a *res*. It is none the less such because the claim is rejected *in toto*, reduced in part, given a priority inferior to that claimed, or satisfied in some way other than payment in cash. * * * "

The administration and distribution of the property of bankrupts is a proceeding in equity. The jurisdiction to inquire and determine who the lawful owners are, and to that end to call before it all claimants by a reasonable notice, and order them to present their claims to the court within a reasonable time, or to be barred of any right or interest in the property in its custody or in its proceeds, is a power inherent in every court of equity, incidental and indispensable to the authority to administer the property in its possession and to distribute its proceeds. *Nisbet* v. *Federal Title & Trust Co.* (C. C. A. 8th Cir.), 239 Fed. 644, cert. den. 241 U. S. 669. And since a bankruptcy court is one of equitable jurisdiction, it is not bound to apply local rules of state law in determining and fixing the relative rights of creditors in the distribution, or in determining the provability and allowability of claims.

> *In re Commonwealth Light & Power Co.* (7 C. A. 1944), 141 F. 2d 734 cert. den. 322 U. S. 766;
> *Farmers State Bank* (1945), 300 Ky. 201, 187 S. W. 2d 793;
> *In re V-I-D Inc.* (7 C. A. 1952), 198 F. 2d 392 cert. den. 344 U. S. 914;
> 1 Collier on Bankruptcy (14th ed.), 168, 169.

Whether creditor claims or stock claims or interests are being determined, the same reasoning may be applied to claims to an interest in a venture or to the capital stock of a corporation which the reorganization court is to determine under §196 of the Bankruptcy Act.

Petitioners' position is unsound. They have not even cited Pennsylvania or New York law of equity as authority for the position they have taken in this case. Instead, they seek an artificial application of technical state corporate law not applicable to the facts in this case and in disregard of the fact that this proceeding is one in bankruptcy.

The Court of Appeals allowed the claims of those claimants who actually invested and contributed in the Nazareth business and real estate. It disallowed the claims of those claimants who acquired their interests from a fraudulent promoter in satisfaction of his personal debts and obligations. The Court's determination was equitable and the Court of Appeals had the jurisdiction and power under the Constitution, Bankruptcy Acts and the cases herein cited to do so.

POINT II

Malakoff did not own the Nazareth venture, the realty nor the capital stock of the Debtor.

Petitioners' fundamental position is based on the premise that Malakoff owned the venture, realty or capital stock of the Debtor. Thus, petitioners' brief (p. 92) "Malakoff himself paid the Philadelphia group $60,000. for the market"; (p. 113): "On July of 1951, Malakoff contracted with the Philadelphia group to buy—and he then acquired an *equitable* interest in the *entire* market property"; (p. 129): "Malakoff expressly undertook to

sell to the stock-claimants what he had individually acquired from Nazareth and what he himself owned".

The fact is that he did not own or pay for any part of the venture, realty or stock of the corporate debtor which he could legally sell or convey or assign.

Malakoff had no substantial funds of his own and did not have funds wherewith to pay for the purchase price of the Nazareth Market [R. 296].

He solicited investments for the Nazareth Market and as he received money from the innocent investor, he made the payments required to be made to purchase the Nazareth Market. Appendix A shows the payments to Malakoff by the investors and his payments to the Philadelphia Group. Malakoff had always received more money from the investors than he had paid to the Philadelphia Group. He received a total of $160,362. and paid out $49,489 of these funds plus $11,032.84 of Debtor's funds for a total of $60,521.84, to the Philadelphia Group.

From first to last, Malakoff's every action was that of a representative for those persons who gave him their money for investment in Nazareth. The evidence to this effect is overwhelming.

a) Malakoff's first action; his solicitation of investments limited his interest to a share of the profits in the event of a sale

In April, 1951, Malakoff purported to syndicate the purchase of a one-fourth interest in Nazareth for $16,000. The entire sum of $16,000. was contributed by claimant Kanter ($4,000.), claimant Samet ($2,000.), claimant, Gertrude Silver Klein ($2,000.) and others. Malakoff's sole interest in this transaction was limited to a share of the profits in the event of a subsequent sale. Malakoff con-

firmed this himself in his own record of the transaction (see legend "1/3 of profit to office" in Saul, General Debtor's Ex. K—R. 543).

In addition, Malakoff told Claimant Kanter that his interest in Nazareth was limited to a share of the profits in the event of the sale of the property [R. 306-7].

b) Malakoff did not consider himself a principal

On August 1, 1951, Malakoff acknowledged to claimant B. Clark that he was "holding in escrow the sum of $4000. which you have invested with me in the deal in Nazareth, Penna., known as The Nazareth Farmer's & Auction Market (sic)." " " " (B. Clark Ex. 5—R. 569). On September 11, 1951, he acknowledged to claimant Masur that he was "holding in escrow the sum of Four thousand dollars which represents one-fiftieth (1 50th) ownership in the Nazareth Farmer's & Auction Market (sic), in Nazareth, Pennsylvania (Masur Ex. 8—R. 566). Again on September 11, 1951, he acknowledged to claimant Treat "receipt of Two thousand dollars ($2000.) which I am holding in escrow, for 2 200ths of the Nazareth Farmer's & Auction Market (sic), Nazareth, Pennsylvania (Treat Ex. 4—R. 568). Similarly, Malakoff acknowledged to other claimants that he was holding their money in escrow (*e.g.*, F. Como Ex. 4—not printed).

The statements made in these exhibits are not those of a man who was selling part of his own proprietary interest or part of his own stock. If Malakoff were selling what was his own, the money he received on the sale would have been his own and there was no need to hold it in escrow.

c) Malakoff acknowledged that the money he collected from the Nazareth investors did not belong to him

As late as December, 1952 or January 1953, Malakoff had a conversation with Gilbert Sunshine, his accountant. Sunshine brought to Malakoff's attention that the books of the corporation showed no indication of the money collected for the sale of stock. Malakoff replied that when final arrangements were made he would put the necessary moneys in the corporate treasury [R. 429-430].

As was the case with the escrow receipts, if the stock sold by Malakoff were his own, the money proceeds of any stock sale would be his own and there would have been no need for Malakoff to acknowledge his obligation to pay the money over to the corporation.

d) Apart from a share of the profit on a sale, all that Malakoff expected in Nazareth was a management fee

As part of the foregoing conversation with his accountant, Malakoff stated that he contemplated a management fee for supervising the Market plus his expenses. This was what he was to get out of the situation [R. 440-441]. There was no claim by Malakoff that he was entitled to any stock. Apart from a share of the profit on a sale, Malakoff's only expectation was a managerial fee for supervising the market for the investors. It is highly significant that the Examiner fixed Malakoff's status in Nazareth as that of "the managing adventurer" [=141—R. 210].

c) The Examiner has found that none of Malakoff's funds were used to pay for Nazareth, that he obtained financing from others and that his interest was limited to a percentage of the profit from the venture

This finding by the Examiner appears at R. 190. It is amply supported by the foregoing references to the record and the fact that Malakoff himself had no substantial funds of his own [R. 296].

f) The Market was paid for with the funds of the investors

We have seen that Malakoff had no money. The investors now before the court gave their money to Malakoff specifically for investment in Nazareth. Publication of a "bar order" invited the filing of proofs of interest by any persons claiming stock interests in this proceeding [R. 45, 229; Bankruptcy Act, sec. 196].

No other persons have claimed that it was their money which bought the property or was contributed to the venture. The State of Pennsylvania has not claimed the property for want of an owner. The conclusion is irresistible that Malakoff used the investors' money to pay for Nazareth even though it may have been comingled with his own.

Hooley v. *Giere*, 9 Abb. N. C. 8, Note on pages 41 and 42, aff'd 9 Daly 104, aff'd 82 N. Y. 625;
Baker v. *N. Y. National Exchange Bank*, 100 N. Y. 31, 34-35.

g) Malakoff's last action—within 4 months of the filing of the Petition for Reorganization, Malakoff perpetrated a fraud in an attempt to constitute himself the owner of Debtor's stock

Late in May or June, 1953, Richard Hull, Esq., prepared a set of minutes purporting to authorize the sale of the balance of 180 shares of the Debtor's stock to John Malakoff for $75 per share. Hull was a director of the Debtor. These minutes [R. 535-6] were dated in one place July 2, 1952 and in another July 2, 1953. The fraudulent nature of the minutes is obvious from the fact that they were pre-dated and signed by Hull after he had resigned as a director on June 4, 1953 [R. 417-8]. They were prepared with knowledge of the over-issuance of stock by Malakoff and after Malakoff was charged with not putting the money received for the sale of stock into the corporate treasury [R. 419].

The Court of Appeals has branded these minutes as having been "fraudulently prepared and pre-dated" and that "The purported issuance was both fraudulent and invalid" [R. 592].

There is only one conclusion to be drawn from these fraudulent minutes—Malakoff was at no time the owner of any stock or proprietary interest in Nazareth. If he were, there would have been no need to draw the minutes. "Malakoff as the promoter must be regarded as a trustee, fiduciary, agent, promoter or syndicater—(the terminology is unimportant—the facts create the rights) for those who gave him their funds for investment in the project." (Opinion by the Court of Appeals, R. 592-3.) The minutes were drawn to cover up Malakoff's breach of trust in transferring interests in Nazareth, which he did not own, in satisfaction of his personal obligations.

POINT III

Malakoff was a promoter in the Nazareth venture. As such, he was a fiduciary bound to act for the investors and whatever he acquired should be impressed with a trust for their benefit.

Malakoff was a "syndicator" and promoter in real estate transactions. Indeed, he used the very word "syndicate" in his record book to describe at least one of his real estate transactions [Saul, General: Debtor's Ex. K—R. 543]. Petitioners acknowledge that, in the acquisition of the Nazareth Market, Malakoff undertook a real estate "syndication" or promotion [Brief, p. 5]. Malakoff was one who associated investors in the acquisition of real property for sale and profit. He did not invest himself and the Examiner has found that he did not in this case [R. 190].

Controlling are the facts which disclose whether the purchase was in fact made by the promoter himself individually, or by the corporation or with moneys contributed by a syndicate organized for the purpose, the members of which are repaid by a pro rata distribution of the shares in the venture or of the organized corporation. [*Parker* v. *Boyle*, 178 Ind. 560, 99 N. E. 986; *Bigelow* v. *Old Dominion Copper Mining and Smelting Co.*, 74 N. J. Eq. 457, 503.]

The money for the purchase of the Nazareth business and realty and for the 20 shares transferred by Zoloth and Soble to Malakoff came from the investors (see p. 40, *post*). The 20 shares were assigned to the Debtor and never came into the hands of any claimant [R. 592]. Petitioners seize on these 20 shares held by Malakoff, being all the outstanding stock, as justification for his issuance

of all the Debtor's stock [Brief, p. 93]. Aside from the fact that Malakoff was holding those 20 shares for the benefit of his principals who furnished the money for whatever he acquired, the mere fact that all the issued stock of the corporation stood in Malakoff's name did not make Malakoff and the corporation one and the same person. It continued as an entity irrespective of him. *Donaldson* v. *Andresen*, 300 Pa. 312; *Macay* v. *Scandinavia Belting Co.*, 264 Pa. 384.

At the outset, it was not finally decided whether the Nazareth project was to be conducted as a corporation or joint venture [R. 187, 308]. In either case, the promotion was in its organization stages even though the Debtor was already incorporated. In determining the relation between joint venturers, it is the nature of the enterprise undertaken by the plurality of persons that controls. *In re Taub* (C. C. A. N. Y.) 4 F. 2nd 993.

As a promoter, there was a relationship of trust and confidence between Malakoff and the persons whose investments he solicited and, for breaching his fiduciary obligations as a promoter, a trust should be declared in whatever Malakoff acquired in favor of his principals who provided the money. *McCandless* v. *Furland*, 296 U. S. 140; *Davis* v. *Las Oras Co.*, 227 U. S. 80; *Sage* v. *Culver*, 147 N. Y. 241, 246, 247; *Brewster* v. *Hatch*, 122 N. Y. 349; *Getty* v. *Devlin*, 54 N. Y. 403, 413; *Hiller* v. *Calmac Oil & Gas Corp.*, 258 A. D. 78, 84; *Zahorsky* v. *Leschinsky*, 394 Pa. 368; *Fidelity Union Trust Co.* v. *Laise*, 127 N. J. Eq. 287.

The basic principles involved are well illustrated in *McCandless* (*supra*) and *Brewster* v. *Hatch* (1890), 122 N. Y. 349.

From these cases it is apparent that whatever legal sleight-of-hand may be used, a promoter will not be permitted to mulct investors by organizing a corporation

and, with the use of their money, purchase its stock and assets for himself and distribute the stock among his creditors in satisfaction of his personal obligations. Since the stock claimants who were personal creditors of Malakoff must rely on his interest in the Debtor to support their claims, and since he had no such interest, the claims are invalid and must be rejected.

That Malakoff commingled the funds entrusted to him is no bar to relief (*Baker* v. *N. Y. National Exchange Bank*, 100 N. Y. 31, 34-35; *Hooly* v. *Gieve*, 9 Abb. N. C. 8; aff'd 9 Daly 104; aff'd 82 N. Y. 625).

In the note to *Hooly* v. *Gieve*, found in Abbott's New Cases at pages 41 and 42, the rules were stated as follows:

> "The old aphorism that 'money has no ear-mark' which was formerly often assigned as a reason for not allowing a fund after it had been reduced to money and mingled with other moneys is now restrained by the growing recognition of the two just and practicable rules of modern equity, which may be stated thus: 1. Where trust moneys have lost their individuality by being comingled with other moneys, or turned into other property, equity may establish a charge on the entire fund, in favor of the cestui que trust, to the extent to which that can be done without injustice to those having other equities in the fund. 2. In doin gthis it may trace the moneys by all the means that bookkeeping and an equitable application of payments afford, so as to fasten on the resulting fund a charge or lien for the amount diverted, so far as the fund may justly be subjected to the trust, but no further.
>
> "If the trust money is thus traceable, the court will not decline to reach it merely because it has been comingled."

POINT IV

Malakoff and the Philadelphia Group deceitfully conceived, created and used the Debtor corporation to effectuate a fraud on the Debtor's existing and future creditors and stockholders.

The slickness of the scheme engineered by the Philadelphia Group and Malakoff to mulct the investors may be seen from the chronology and character of their maneuverings. This requires a detailed analysis of their conduct.

On April 17, 1951, the Philadelphia Group acquired the business and realty of Nazareth from Richard Realty Co., its dummy [=17—R. 51-2; R. 282-3].

The purchase price according to the closing statement was $66,000, subject to two mortgages totalling $18,500. [Saul, General: Examiner's Ex. G—R. 531; =17—R. 51-2].

The actual cash payment made by Richard Realty Co. was $47,732.99, inclusive of $5000. paid on account and minor adjustments, all of which are reflected on the closing statement.

Zoloth and Soble were dummies for the Philadelphia Group [R. 286-7]. Their books reflected their capital investments (of $40,000), as well as the capital investment (of $17,489) of John Malakoff, which were used to pay the cash required for the purchase price [Saul, General: Examiner's Ex. BU—R. 507].*

* John Malakoff's capital was furnished by Kanter, Silver, Samet and others as reflected on his record book [Saul, General: Debtor's Ex. K—R. 547; Finding No. 3—R. 230]

At this point, the first step on the road to fleece the public was taken. In July, 1951, John Malakoff orally agreed to purchase the Nazareth business and real estate for the same $66,000. paid by the Philadelphia Group plus "an unresolved amount" [Finding =7—R. 231]. Shortly after this oral agreement, arrangements were made for the organization of a corporation (the Debtor) to take over the Nazareth property and business; in anticipation thereof, the capital investments of Soble and Malakoff were converted to loans [=21—R. 52-3, Saul, General: Examiner's Ex. BU—R. 507].

Thus, Soble's original capital investment of $40,000. and Malakoff's original capital investment of $17,489. were converted to loans. These loans, in effect, represented the purchase price of the property. To the loans was added $9,794.64 expended for repairs. After allowance for depreciation and the allocation of $1500. of Soble's loan to capital, the total loans appearing on the Zoloth and Soble books on August 7, 1951 amounted to $57,135.92 [=25—R. 54; Saul, General: Examiner's Ex. 1—R. 533].

It must be remembered that the cash paid by the Philadelphia Group for the business and realty was $47,732.99. There seems little doubt that the $9,794.64 expended for repairs less the allowance for depreciation represented the "unresolved amount" to which the District Court referred. After allowing for repairs and depreciation, the loans of $57,135.92 in reality represented the purchase price of the Philadelphia Group.

The second step was now taken.

The Debtor had been organized on or about August 1, 1951 [=22—R. 53]. On August 9, 1951, at a meeting of its directors, 20 shares of the Debtor's stock were issued

equally to Zoloth and Soble on the basis of the assets (the Nazareth business and realty) and liabilities listed on their balance sheet. *The Debtor* (not Malakoff) *assumed payment of the loans* and Soble's $1500.00 was applied to the payment of the 20 shares of stock [=24, 25—R. 53-4].

The loans, now assumed by the Debtor, were the same loans appearing originally as capital investments on the books of Zoloth and Soble and, with the adjustment for repairs and depreciation, continued to be representative of the purchase price.

The loans payable on the Debtor's books were carried as receivables on the books of the Philadelphia Group [Saul, General: Examiner's Ex, J—R. 537].

At this point, the corporation was rendered insolvent and remained insolvent up to the time of the filing of the petition.

In 1951, with a net worth of $1500., it was obviously under-capitalized. It is just as obvious that it could not pay its obligations because current liabilities were $4,758.16 and current assets, consisting of cash in bank and on hand amounted to $1,217.17. There were no accounts receivable. Current liabilities exceeded current assets by $3,340.99. Thus, as a matter of fact, the Debtor was undercapitalized and was equitably insolvent [R. 512-513].

In 1952, liabilities exceeded assets so that the Debtor was insolvent in a bankruptcy sense. In fact, it was overdrawn at the bank and its current assets of $50. on hand could not possibly meet $1,024.37 in current liabilities [R. 514].

In 1953, Debtor was still overdrawn at the bank. Excluding a questionable account receivable from Malakoff

amounting to $11,811.78, current assets were exceeded by current liabilities [R. 518]. The Debtor could not pay its bills as they became due [R. 400].*

The third step was now taken.

On October 17, 1951, Malakoff purchased the 20 shares of stock owned by Zoloth and Soble for $32,853.08. [Saul, General: Debtor's Ex. F—R. 540.] The stock certificates were endorsed over to Malakoff but were held in escrow and the Philadelphia Group also retained the corporate books and books of account [#30—R. 55-6].

The fourth step was now taken.

Although Malakoff had solicited the funds of Kanter and others in April 1951 [Saul, General: Debtor's Ex. K —R. 547, Finding #3—R. 230], he continued in earnest to solicit the funds of investors for investment in Nazareth. All told, from the beginning of his solicitation to March 25, 1953 Malakoff solicited and received $160,362. from the investors [Appendix A]. As he received this money, he made payments to the Philadelphia Group in reduction of the loans carried on their books. Up to February 15, 1962, Malakoff paid $49,489. and the Debtor paid $11,032.84 to the Philadelphia Group in reduction of the loans. The total payment amounted to $60,521.84 [Appendix A].

Although Malakoff's payments to the Philadelphia Group were reflected in its books, [Saul, General: Exam-

* During the period from 1951 to 1953, creditors of the Debtor had no fund to look to for the payment of their debts because the money of the investors, which should have reached its treasury, were either paid over to the Philadelphia Group or kept by Malakoff. [*Topel* v. *Coleman*, 229 F. 300, 304, cited with approval in *McCandless* v. *Furland*, 296 U. S. 140, 162; *Bingaman* v. *Commonwealth Trust Co.*, 15 F. 2nd 119.] Thus, the interests in Nazareth purchased by the investors were worthless.

iner's Ex. J—R. 538-9] and the loan of $57,135.92 were not only paid but overpaid, *there was no corresponding reduction made of those same loans on the books of the Debtor.*

The fifth step saw the loans on Debtor's books as owing to Malakoff instead of the Philadelphia Group. This was done sometime before June 30, 1952 when the exact balance appearing on the Zoloth and Soble books as loans appeared on Debtor's books as owing to John Malakoff [=37—R. 57; Cf. Saul, General: Examiner's Ex. BU—R. 507 and Saul General: Examiner's Ex. BY R. 514, 516, 518].

The sixth step was the delivery of Nazareth's books by the Philadelphia Group to Malakoff in December, 1952 [=30—R. 56].

The seventh step was the issuance of stock certificates by Malakoff beginning in February 1953 to investors and non-investors alike [Saul, General Examiner's Ex. 4 not printed].

The eighth and last step was taken late in May or June, 1953 when Malakoff's game was up. He caused the preparation of a set of predated minutes which purported to have all the Debtor's stock issued to him by reducing the loan on Debtor's books which appeared as owing to him. The Court of Appeals has found these minutes to be fraudulent [R. 592].

Malakoff and the Philadelphia Group gyrated along their fraudulent road from one entity to another and from one transfer to another with this result:

The conversion of the capital investments in Nazareth resulted in an obligation imposed on the Debtor and the investors to pay twice for the same property.

Putting it in the simplest terms, the purchase price was $57,135.92 which was carried on the books of the Philadelphia Group as a loan. This was the same loan assumed by the Debtor when it issued twenty shares of stock to Zoloth and Soble.

Malakoff paid for that loan with investors' funds.

The Philadelphia Group knew as early as April, 1951 that Malakoff was using the funds of others in acquiring the Nazareth business and realty [R. 306]. They knew also that of the $60,521.84 they received in payment of the loan, $11,032.84 consisted of windstorm insurance proceeds and was paid by the Debtor [R. 285]. With this knowledge, they connived with Malakoff so that the loan appearing on Debtor's books as owing to them was changed to appear as owing to Malakoff. This was done by June 30, 1952.* The change could not have been accomplished by Malakoff alone. The help of the Philadelphia Group was necessary because the Debtor's books of account were in their possession until December 1952 [=30—R. 56].

The extent of their dishonesty may be judged from the fact that during all the times they were noting payments in reduction of the loan on their own books, the Philadelphia Group never made corresponding notations on the books of the Debtor whenever any of the reducing payments were made.

We have, therefore, Malakoff using the investors' funds and the Debtor's funds to pay off the Debtor's loan obligation to the Philadelphia Group. Instead of marking it paid, the Philadelphia Group transferred the obligation to Malakoff. The Debtor was thereby left in the position of being once again required to pay for the

* Conceded in petitioners' brief on page 15.

same loan to Malakoff. In effect, the Debtor and the investors were placed in the position of having to pay the purchase price for the market property twice—*once*, by the payment by Malakoff to the Philadelphia Group with the investors' money which should have reached Debtor's treasury and, a *second time*, as loans owing to Malakoff on Debtor's books which in fact represented the same purchase price already paid with the investors' funds to the Philadelphia Group. Essentially, it was the investors as equitable owners of the Debtor who were placed in jeopardy of paying again for the same property. This was the result sought to be achieved by Malakoff and the Philadelphia Group and it was only prevented when Malakoff came to the end of his crooked road in June of 1953.

Not only did the scheme create the jeopardy of a double payment but even more important it placed Malakoff in a position where he had color of title to the only issued shares of Debtor's stock and in a position to obtain color of title to all of the Debtor's stock as well as the loans on its books.

Already noted is the fraudulent nature of the predated minutes caused to be prepared by Malakoff in an attempt to use the loans on Debtor's books as the justification for the issuance of all Debtor's stock to himself. The fictitious nature of the loan is evident from yet another source. At the end, when Malakoff's frauds were discovered in June, 1953, he assigned to the Debtor the 20-shares of stock he received from Zolath and Soble and also released the loan on Debtor's books [=37—R. 57]. In releasing the amounts allegedly owing to him by the Debtor, Malakoff himself knew there really were no loans owing to him. He described his claims as being "for services rendered" [Saul, General: Debtor's Ex. Q—R. 555].

Petitioners recite [Brief, p. 15] that on October 17, 1951, when Malakoff purchased the 20 shares of stock from Zoloth and Soble for $32,853.08, that "In addition, Malakoff personally assumed liability to the Philadelphia Group for the 'loans payable' to them". This is not true. The contract for the sale of the stock [R. 540] contains no such provision. Moreover, by October 17, 1951, the Philadelphia Group had already received $34,989. from Malakoff [Appendix A] leaving a balance due on the loans of $22,146.92. How can it then be said that Malakoff assumed to pay $57,135.92 when only $22,146.92 was due? Further, the total loans of $57,135.92 included $17,489. previously converted from "his" capital investment. Thus, of the balance of $22,146.92, the sum of $17,489. was ostensibly due Malakoff. Petitioners' contention that Malakoff assumed payment of the total loans is ridiculous because Malakoff would not assume to pay a loan due to himself.

There is another matter of fact in connection with the purchase of the 20 shares which merits some comment. The Examiner erroneously found that the total price of Nazareth to Malakoff was $89,989. consisting of the loans of $57,135.92, plus $32,853.08 for the stock [3]. This was rejected by the District Court which found the price to be $66,000., plus an unresolved amount [R. 231]. The reason for the rejection seems clear. Malakoff had agreed to purchase the Market business and realty in July, 1951 for $66,000. That was the price. When he purchased the stock for $32,853.08 on October 17, 1951 there was no reason to add the price of the stock to the price for the Market previously agreed on in July 1951. It would be more consistent to apply the price of the stock to the previously agreed upon price. *The contract for the sale of the stock was merely a change in the format of paying*

the cost of the property. This is fortified by the fact that nowhere in the findings of the District Court was there any mention made of the price of $32,853.08 for the stock.

Petitioners profess to be concerned with the realities in Nazareth [Brief, p. 92]. They point to the so-called loan appearing on Debtor's books as a credit to John Malakoff which he released. From this they argue that the first 20 shares were split 10 for 1 and that the 20 authorized shares "should have been capitalized at no less than $60,000. after Malakoff released the loan" [Brief, pp. 92-93].

This is pure fiction. In the light of what has been demonstrated, all the euphemisms in the world cannot cover the fact that Malakoff and the Philadelphia Group were frauds.

POINT V

A Bankruptcy Court as a Court of equity may, in a proper case disregard the corporate entity or pierce the corporate veil.

The evidence discloses:

1. That Malakoff dominated and controlled the Debtor [=129—R. 204].

2. That to the majority of investors, it was no more a separate entity than it was to Malakoff; they considered themselves as investing in Nazareth as a business enterprise in a joint venture with Malakoff as the managing venturer [=130—R. 205; =131—R. 206; =138—R. 208].

3. Malakoff and the investors understood and agreed that at the most, the debtor was merely a transitory

vehicle, receptacle or conduit holding technical title to the Nazareth business and realty for all the joint venturers and that title might be and could be transferred to another vehicle such as a limited partnership.

> "On the other hand, I may cause the dissolution of the corporation and arrange the formation of a limited partnership and your shares will be applied as your contribution with a corresponding proportionate 'interest' " [R. 187].

Investors gave him contributions under those conditions before, during and after the purchase of the Nazareth Realty and business [=130—R. 205].

In said receipt, he further stated:

> "Under our arrangement, I am obliged to you for a proportionate share of my earnings, dividends, liquidating or otherwise, and profits from the market as I receive them" [R. 186].

4. Malakoff was not selling shares of stock; he was selling fractional interests in Nazareth with a 20% annual return based on the amount of money invested by each buyer of an interest [=127—R. 204].

For stock purposes, he did not consider the Debtor as a legal entity separate and apart from himself [=129—R. 204]. The Debtor and Malakoff were alter egos [=133—R. 206].

5. The Debtor was conducted as a *de facto* corporation; it never completed its organization by the regular issuance of stock, the regular election of directors and officers, the regular conduct of meetings of stockholders and directors and other corporate activities [=131—R. 206].

The plan conceived by Malakoff and the Philadelphia Group involving the purchase and sale of the Nazareth property was a fraud, rendered the Debtor corporation insolvent from its very inception to its demise and was a fraud on its creditors and investors [Point IV, *ante*].

The investors, whether they were buying shares in a venture as claimed by the Debtor, or the Debtor stock, or Malakoff's interest as claimed by the petitioners, were buying absolutely worthless pieces of paper [Point IV, *ante*].

Thus, the Debtor corporation was deceitfully conceived, created and used as a means to effectuate a fraud. If we take into consideration the further facts that the investors and Malakoff agreed that the Debtor corporation was a mere transitory vehicle for the Nazareth property, and that most of the investors were buying an interest or share in the Nazareth market, business, or venture, this Court, in all good conscience and equity, should disregard the corporation or pierce the corporate veil and treat the transaction as a joint venture. A trust should be imposed on the only asset of that venture, the Nazareth property and business, thereby enabling this Court to look to the real substance of the issues and facts involved, and not to the *inapplicable*, highly technical statutes and decisions of state courts presented by the petitioners.

Because of technical requirements under Chapter X of the Bankruptcy Act, the Debtor was required to file its petition as a corporate Debtor and for that reason only.

The Federal Courts have disregarded the corporate entity to do equity in bankruptcy and in other cases.

Fitzgerald v. *Central Bank & Trust Company* (C. A. 10th 1958) 257 F. 2nd 118;

Selected Investments Corp. v. *Duncan* (C. A. 10th 1958) 260 F. 2nd 918, cert. den. sub. nom. 359 U. S. 914 (1959).

All states including Pennsylvania and New York have pierced the corporate veil or disregarded the corporate entity to do equity and substantial justice.

The very law of Pennsylvania, which petitioners would have applied here, invokes the broadest kind of equitable application of the principle of disregarding the corporate entity and piercing the corporate veil. For all practical purposes, they disregard the corporate entity theory where equity and justice require it.

In *Tucker* v. *Binenstock*, 310 Pa. 254, 263, the Court held that there is an exception to the fiction that a corporation is an entity distinct from the aggregate of individuals comprising it and that this fiction will be disregarded and the individuals and corporation treated as identical whenever justice or public policy demand it and when the rights of innocent parties are not prejudiced thereby nor the theory of the corporate entity made useless. See also: *Williams* v. *Rose*, 403 Pa. 619, 624; *E. Silk Mfg. Co.* v. *First N. B. & T. Co.*, 338 Pa. 139, 143; *Markovitz* v. *Markovitz*, 336 Pa. 122; *Love* v. *Clayton*, 287 Pa. 205, 213.

New York Courts have looked behind or disregarded the corporate form where equity and justice require it. *Goss & Co.* v. *Goss*, No. 2, 147 App. Div. 698; *Barkin Const. Co.* v. *Goodman*, 221 N. Y. 156.

In *Hodlin* v. *Licht*, 224 App. Div. 614, the Court stated at page 615:

> "The parties were essentially joint adventurers, and, as such, owed the duty of utmost good faith

> to each other. They were accountable for secret profits." (Selwyn & Co. v. Waller, 212 N. Y. 507.) Where as in this case, the defendants' conduct was not honest, equity will look behind the corporate form and consider the parties in their real relation to each other (Goss & Co. v. Goss, No. 2, 147 App. Div. 698). * * * "

The result of piercing the corporate veil or disregarding the corporation would present the Nazareth transaction in its true light and enable this court to do equity and substantial justice.

The fact that some investors gave Malakoff monies for investment for the Nazareth venture before, during or after the purchase of Nazareth, and that he gave more interests than he represented were to be distributed, or more shares of stock than were authorized to be issued, becomes academic because his purchase enures to the benefit of all investors or subscribers in proportion to their actual contributions [*Getty* v. *Devlin*, 54 N. Y. 403, 412, 413]. The time of the purchase of the realty, the time of payment by the investors, the time of delivery of shares of stock or that more than 200 shares were issued are not crucial. Substance must not give way to form [*Pepper* v. *Litton* (1939), 308 U. S. 295, 305].

The stock claimants would be treated as what they truly were—investors as venturers in a joint venture with Malakoff as managing venturer.

The *res* of their investment likewise would in fact come into true focus. This would clearly not be the corporation but the Nazareth business and realty.

The *res* to be distributed, which is in fact the Nazareth business and realty, would be more adaptable to realistic

and simple allowances based on the money invested index used by the Court of Appeals which can easily be translated into shares of stock within the existing framework of the Nazareth corporate structure.

In addition, all of the guilefully and technically created theories of the petitioner relating to State and corporate law (e.g., that a court of equity has no power to cancel the stock certificate * or disallow the interest ** in the debtor corporation of a claimant stockholder) could be justly dispensed with.

POINT VI

Based on fundamental differences, the Court of Appeals properly allowed the claims of investors and disallowed those of the non-investors.

The crucial differences between the situations of the investors as compared with those of the non-investors furnishes every reason for allowing the claims of the investors and disallowing those of the non-investors.

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* It is well established law that a Court of Equity may declare the issuance of fictitious stock void, and have such stock cancelled (*Bingaman* v. *Commonwealth Trust Co.* (M. D. Pa. 1926) 15 F. 2nd 119; *Chemical Lime Co.* (M. D. Pa. 1938) 25 F. Sup. 547; *Frazer Fund* v. *Frazer*, 350 Pa. 553; *Petrishen* v. *Westmoreland Finance Corporation*, 304 Pa. 552; *B & C Electrical Construction Co* v. *Owens*, 176 App. Div. 399, affd. 227 N. Y. 569; *McCandless* v. *Furlaud* (1935), 296 U. S. 140, page 161.

** The petitioners can only contend that the effect of the Court of Appeals disallowance of the claims of non-investors resulted in a cancellation. But a Court of Bankruptcy has the power to disallow creditors' claims and "the interests of stockholders" under §96 of the Bankruptcy Act. The natural result of disallowance would be cancellation or nullification.

Intention to Invest

The purpose of the investors was to purchase an interest in Nazareth.

There was no intention by the non-investors to make an investment in Nazareth. They received their interests in satisfaction of Malakoff's personal obligations to them.

Actual Investment

The investors, through Malakoff, invested their money and made a contribution to the venture. Money was actually passed.

The non-investors did not invest any money and made no contribution to the venture. All that happened was that Malakoff's past due personal obligations to them were satisfied. They received participation in the venture but neither the venture nor the Debtor received anything.

Good Faith and Change of Position

The investors gave their money to Malakoff for the specific purpose of acquiring an interest in Nazareth. Whatever he acquired was theirs. They relied on him for this purpose and they changed their positions to the extent that they parted with money. They were good faith purchasers.

The non-investors received their interests from Malakoff in satisfaction of their personal claims. There was no change in their positions. The allowance of their claims may not be predicated on any theory of estopped against the venture or the Debtor based on any misrepre-

sentations of Malakoff. An antecedent debt does not support a good faith purchase or an estoppel sufficient to cut off prior equities. *Wills* v. *Investors Bankstocks Corp.*, 257 N. Y. 451, 458; *Helvering* v. *Schine Theatre Chain Inc.* (2 C. A. 1941), 121 F. 2d 948, 950). This is conceded by the petitioners (Brief, p. 87).

The Nazareth project was a joint venture (=138—R. 208) and, at most, Malakoff was the "managing venturer" (R. 206). The investors relied on him as representative of the venture to acquire their interests. Whatever he acquired was theirs. The non-investors were engaged in a private and personal transaction to which the venture or the Debtor corporation was a stranger. This was evident or should have been evident to the non-investors, whose personal claims against Malakoff were being satisfied with venture or corporate interests. Under such circumstances, Malakoff, as agent for the venture or the Debtor corporation, could not bind his principal where he was known to be acting for himself. *Manhattan Life Insurance Co.* v. *The Forty-Second Street Company*, 139 N. Y. 146, 151; *N. Y. and New Haven R. R. Co.* v. *Schuyler*, 34 N. Y. 30, 50.

Effect on Debtor's Creditors

Creditors have the right to look to the money value of a corporation's paid up capital as a trust fund for the satisfaction of their claims. This is the law in the Federal courts, in New York and in Pennsylvania. (*First National Bank* v. *Cornell*, 8 A. D. 427, 430, 431; *Tejel* v. *Coleman*, 229 F. 300, cited with approval in *McCandless* v. *Furland*, 296 U. S. 140, 162; *Bingaman* v. *Commonwealth Trust Co.*, 15 F. 2d 119; *Columbia Bank's Estate*; 147 Pa. 436, 23 Atl. 625, 626, 628.)

By statute, in New York and Pennsylvania, the issuance of corporate stock requires value to the corporation (Pa. Constitution, Art. XVI, S. 7; New York Stock Corporation Law, Section 69).

In the case of the investors, money was intended to be paid and was actually paid and therefore constituted, or could have constituted, a trust fund for the payment of creditors.

In the case of the non-investors, no money was paid. Further, no money was intended or could have been paid to the Debtor by the non-investors because the satisfaction of Malakoff's personal obligations could not have resulted in anything being paid into the Debtor's treasury and therefore did not constitute, nor could it have constituted, a trust-fund for the payment of creditors.

Effect on Malakoff's Creditors

If Malakoff were the owner of the Nazareth project, all of his creditors would be entitled to share in it on an equal basis. However, Malakoff was not the owner. To allow claims on the basis of satisfaction of Malakoff's personal obligations would spread the ownership of the Debtor's stock to all of Malakoff's creditors as well as among all the creditors of any corporation Malakoff had anything to do with. For example, Seymour Forman received stock from Malakoff as security for loans made to the Wales and Ambassador corporations [R. 315-17].

If any of the Nazareth claims of Malakoff's creditors are allowed, the result would be a preference over all of Malakoff's creditors because he was insolvent [=37—R. 57].

This proceeding does not involve the matter of John Malakoff as a bankrupt or in reorganization. We are

here concerned with determining the legitimate owners of the Debtor. Both in principle and as a matter of practicality there is no occasion for going beyond this limit by adjudicating the personal affairs of John Malakoff.

Petitioners suggest [Br., p. 923] that the 20 shares of stock held by Malakoff "should have been" recapitalized on the basis of the loans appearing on Debtor's books as being loaned to Malakoff. The "loans", however, had been paid off (*ante*, p. 38) and no longer existed. Therefore, the suggested recapitalization could add nothing to the Debtor's treasury to which creditors could look to as a fund for the satisfaction of their claims. As was stated in *Tepel* v. *Coleman*, 229 F. 300, at page 304:

"This doubtless is not valid even so far as it concerns the corporation, much less as against the trustee in bankruptcy who here stands for creditors of the corporation. *Guarantee T. & T. Co.* v. *Dilworth Coal Co.*, 235 Pa. 601, 84 Atl. 516."

Moreover, Malakoff himself attempted what amounts to the recapitalization suggested by petitioners when he caused a pre-dated set of corporate minutes to be drawn. The Court of Appeals found the minutes and the purported issuance of stock to Malakoff to be invalid and fraudulent [R. 592].

The recapitalization suggested by petitioners is the very situation which the Pennsylvania Constitution, *supra*, and statutes were designed to prevent. In *Zweifach* v. *Scranton Lace Company*, 156 F. Supp. 384, 391, quoting *Grafton* v. *Masteller*, 232 F. 2nd 773, 775, the Court pointed out:

> "The constitutional and statutory provisions * * * were designed to prevent unscrupulous persons from fraudulently issuing and placing on the

market * * * stock not fairly representing money or property received by the corporation." *Big Spring Elec. Co.* v. *Kitzmiller*, 1920, 268 Pa. 34, at page 38, 110 A. 783, at page 784; cf. *Memphis & L. R. R. Co.* v. *Dow*, 1887, 120 U. S. 287, at pages 297, 298. 7 S. Ct. 482, at pages 486, 487; 30 L. Ed, 595."

A corporation may not issue stock for its antecedent indebtedness. *In re Paul Delaney Co., Inc.* (W. D. N. Y. 1927), 23 F. 2nd 737. Neither may a corporation issue stock for a corporate indebtedness to an officer. *In re Progressive Wall Paper Corp.* (2 C. A. 1946), 229 F. 489.

Contributions to the Estate Are Required for the Allowance of Stock Claims

The non-investors paid nothing and having made no contribution they are not entitled to a decree awarding them ownership in any portion of the estate in reorginzation.

The Money Invested Index

The money invested index used by the Court of Appeals was proper.

Petitioners complain about the allowance of claims on the basis of the amount of money invested [Brief, p. 40]. The use of a money index in the making of an equitable determination is by no means novel.

Getty v. *Devlin*, 54 N. Y. 403, was a case involving the application of equitable principles in a case turning on a fraudulent land promotion which was similar in principle to the Nazareth situation.

In *Getty*, the New York Court of Appeals stated [p. 415]:

> "The balance (over the purchase price) equitably belongs to those who paid the money * * * ".

Parenthetically, in granting a new trial, the Court of Appeals in *Getty* observed for the benefit of the Trial Court that

> "It may also be that there should be a re-distribution of the stock among the bona fide subscribers alone" [p. 416].

This is in line with the distribution made by the Court of Appeals below which awarded stock interests solely to the investors.

There Is No Windfall to the Investors by Disallowing the Claims of Non-Investors

Petitioners argue that the result of the Court of Appeals decision is an unearned windfall to the investors whose claims were allowed and point to claimant Weinstein as an example [Brief, p. 48].

In 1952, Nazareth liabilities exceeded its assets [R. 514].

In 1953, there was a surplus of $11,077.68 [R. 518] but Nazareth could not pay its debts as they became due [R. 400].

The fact is that during all that time Nazareth was insolvent and Weinstein had a 4.365% or a 3.5% interest in nothing.

There is no windfall. Had there been no fraudulent maneuvering by Malakoff, it is reasonable to expect that 200 shares would have been sold and $200,000. paid into the venture or into the Debtor's treasury. This might have consisted of the property purchased for $66,000. and the balance would be cash for a total of $200,000. Under these circumstances, Weinstein would have been the owner of a 3.5% interest worth $7,000. Petitioners' arithmetic is wrong. Weinstein's percentage interest under the Court of Appeals decision is $7,000. over $160,362. which was the total money value, inclusive of the Margolis and Shongut allowance, of the stock claims allowed. This amounts to 4.365% instead of 4.79% as computed by petitioners. However, what Weinstein was awarded was 4.79% of Nazareth which in 1951 had a net worth of $1500. what with mortgages and loans on its books and with current liabilities in excess of current assets [R. 513].

Cost, though not conclusive, is evidence of value. *McCandless* v. *Furland*, 296 U. S. 140, 158. *Arguendo*, even if it be considered that the value of the property was $89,989. which the examiner erroneously found to be due the Philadelphia Group from Nazareth and Malakoff, Weinstein would be entitled to 4.365% of property worth $89,989. which amounts to $3,928.02. This is an outside figure. The property was purchased on April 17, 1951 for $66,000 [R. 531].

POINT VII

Petitioners' contention that Debtor's failure to appeal from the District Court's dismissal of its counterclaim is *res judicata* should not be sustained.

Because of the nature of the *Nazareth* case, Debtor interposed a defense and counterclaim to all of the stock claims. The following is an excerpt of the defense and counterclaim which were contained in Debtor's objections to all of the stock claims:

> "7. That in the event claimant's claim is sustained that he is the owner of shares, then claimant is indebted to the debtor for the sum of $———— the unpaid subscription price.
>
> "WHEREFORE, the Debtor prays that the stock claim No. ——— of ———————— as owner of shares of the capital stock of Debtor be disallowed and that in the event the Court decides that ———————— subscribed to or is the legal or equitable owner of the stock certificate held by him for which the claim is filed, then in that event the Debtor be awarded judgment for the sum of $. . . . . or at the rate of $1000. per share of stock, or such other balance as the Court deems proper and due and owing to the Debtor by the said claimant."

Subsequent to the filing of said objections, Martin H. Philip, Esq., as a principal and as attorney for Rehrig, who had an interest adverse to the Debtor, with the assistance of Melvin Lloyd Robbins, Esq., counsel for the petitioners, commenced a raid on the Debtor's stock in an effort to acquire control over it.

On August 1, 1960, Weinstein, Philip and Danciger had become officers and directors of the Debtor [R. 226-28]. Philip is one of Rehrig's attorneys and, as pointed out in Debtor's brief in #26362, he represents an interest adverse to the Debtor. Thus, Philip acting for the petitioners, who had purchased large blocks of stock from non-investors, and Danciger were in control of the Debtor corporation.

The counterclaims were dismissed by the District Court on October 19, 1960 when the stock claims were decided [IV—R. 243].

The District Court allowed the stock claims of the Rehrig Group in part and of Danciger in full.

When the District Court's order resolving the stock claims was made, the Board of Directors, controlled by Philip and Danciger, did not authorize Debtor's attorney to appeal from that order and even refused to authorize payment of the printing bill incurred for the Debtor [S. M. 12939-40 not printed].* He did submit a brief stating the Debtor's position when the petitioners appealed to the Court of Appeals in an attempt to have a greater number of their shares allowed. Weinstein, however, as President, in the interests of the Debtor had authorized the printing of this brief to the Court of Appeals [S. M. 12941, not printed].* Weinstein, as President, instructed Debtor's attorney to take an impartial and disinterested position irrespective of who might be hurt [S. M. 12967, not printed].* Fortunately, others had appealed from the allowance of the Rehrig and Danciger claims and Debtor had an opportunity, as appellee, to present its version of the claims, both allowed and disallowed.

* Hearing before the District Court on November 6, 1961

Petitioners now claim that *res judicata*, bars cancellation of the stock of non-investors because of the law of Pennsylvania which they claim requires an assessment before cancellation may be effected [Br., p. 99]. They argue that, since the Debtor did not appeal from the disallowance of its counterclaims, it is now concluded on that matter. This is a perversion of the doctrine because Philip and Danciger were serving their own interests and not those of the Debtor when they did not authorize an appeal from the Debtor from whatever number of their shares were allowed by the District Court and from the disallowance of the Debtor's counterclaims. They acted in complete disregard of the duty imposed on Debtor's attorney, as its representative, to object to the allowance of improper claims [Bankruptcy Act §47(8)] and to report to the judge (in this case the Court of Appeals) as to any causes of action available to the estate [Bankruptcy Act §167(3)]. They should not now be heard to cry *res judicata* by reason of the very situation they themselves brought about.

—o—

On the subject of *res judicata*, it may be observed that the treatment of the Margolis and Shongut claims by the Court of Appeals was on the same basis as were those now in issue before the Court. There has been no Petition for Certiorari filed in those cases and the time to do so has expired. The determination as to them is now final.

POINT VIII

The cabal exposed, the final result was that the Debtor and the investors were cheated and Malakoff and his personal creditors obtained muniments of title based on fraud and deceit.

Despite the gyrations of the Philadelphia Group and Malakoff, and the torturous labyrinth of facts and arguments which required deep analysis, the net result of what was accomplished in this venture has been established and is clear:

1. *The Debtor was rendered insolvent from its inception and remained insolvent down to the time of the filing of the petition for reorganization.* This was a fraud on existing and future creditors and stockholders within the purview of the Bankruptcy Act. *What was being sold to the investors were worthless pieces of paper.*

2. *There was no fund to which existing and future creditors of the Debtor could look for the satisfaction of their claims.*

3. *The Debtor and the investors were placed in the position of having to pay the purchase price for the market property twice—*

once, by the payment by Malakoff to the Philadelphia Group with the investors' money which should have reached Debtor's treasury, and

a second time, as loans owing to Malakoff on Debtor's books which in fact represented the same purchase price already paid with the investors' funds to the Philadelphia Group.

Essentially, it was the investors, as equitable owners of the Debtor, who were placed in jeopardy of paying again for the same property.

4. *John Malakoff was fraudulently enriched as follows:*

A. *Malakoff pocketed $101,366.* This resulted from his collection of $160,362 from the investors, out of which he paid out only $58,996 (Appendix A).

B. *At least $62,946.97 of Malakoff's personal obligations were paid with Debtor's stock.* This is exclusive of the amounts included in the disallowed portion of the Margolis claims which are estimated at $35,000. The total is made up from the shares of the following claimants:

$20,000.00—Manoochehrian	—Satisfaction of a loan to a corporation other than Debtor (R. 596).
$12,000.00—Kanter	—Shift of a worthless investment in Ambassador Estates, Inc. for 20 shares of Nazareth stock (R. 61, 2: 336).
$10,946.97—Danciger	—Payment of personal notes of Malakoff (R. 151).
$10,000.00—H. Forman	—Security for Malakoff's debts (R. 596).
$10,000.00—S. Forman	—Stock issued by Malakoff for at least this amount to secure loans of a corporation other than Debtor (R. 161).
$62,946.97 *	

*This list is not complete. It has been most difficult in some cases to determine what, if anything, was personally owed by Malakoff to some of the claimants. For example, Katzenell told 3 different stories regarding his accounts with Malakoff and the District Court was constrained to observe: "They may fit to you, Mr. Katzenell, but they don't fit to me without a shoehorn" [R. 389].

C. *$57,135.92 in loans appearing on the Debtor's books and ostensibly owing to Malakoff.*

5. *The investors contributed $160,362. to the market venture as against the cost of acquisition of $57,135.92 as represented by the loans on Debtor's books.* Dollar amounts in excess of the cost of acquisition have been allowed with the result that the money value of the investors' shares has been diluted to accommodate all persons who contributed to the venture.

This was the result although Malakoff did not invest or contribute one cent of his own money to the Nazareth venture or the Debtor corporation.

Under all of the circumstances, the one statement by petitioners with which the Debtor will agree is stated at page 15 of petitioners' brief—"The transaction shows their (the Philadelphia Group and Malakoff) financial sophistication." Sophistication of this type in the handling of a transaction of this nature is more aptly described as fraud and embezzlement. Only artificially contrived legal sophistication can sustain the arguments and achieve the results desired by petitioners.

CONCLUSION

The decision of the Court of Appeals should be affirmed.

CASE TWO

(No. 26362)

SUMMARY OF ARGUMENT AND POINT I

The Court of Appeals was correct in recommending the retention of successful management.

The Debtor filed its petition for reorganization in September, 1953.

Weinstein was President and Fried was retained as General Manager. The Court of Appeals has found that: "the administration has been successful, gross business having tripled from 1953 to 1959 and profits have risen from zero to $41,269."

Under the management of Weinstein and Fried, the market has changed from an itinerant business with spotty rent collections to the point of high occupancy ratio with reasonably constant rent collections [R. 454].

From a business which was insolvent in 1953, the Debtor has progressed under the management of Weinstein and Fried so that all of its bills are discounted [R. 453-4].

Under the management of Fried and Weinstein, a building was erected in 1956 at a cost of $32,000, for which the Debtor received $60 or $70,000, as insurance when it was destroyed by fire a year later with a resultant gain to the Debtor of some $30 to $40,000 [R. 456].

Martin H. Philip's election as a director and officer of the Debtor was confirmed by the District Court and in addition, the District Court, of its own volition, designated Martin H. Philip in sole charge of the affairs of the

Debtor [R. 227-28, 495]. The District Court also approved Danciger, whose stock claim was disallowed, as an officer and director. The Court of Appeals reversed the placement of Philip in sole charge of Debtor's management.

Philip is counsel to Wilson D. Rehrig, the real party in interest in this proceeding, and is a participant with Rehrig in the purchase of stock of the Debtor [Pet. Br., 8, 9; R. 227, 575-6, 583]. He has represented Rehrig in his negotiations for a preferential lease from the Debtor [R. 458-9]. Rehrig has admitted under oath that if he had a voice in Debtor's management he would use it to serve his own self-interest by giving himself a preferential lease to the detriment of the Debtor [R. 445].

Philip's first allegiance is to his client Rehrig. Where Rehrig is out to gain control of the Debtor for his private benefit, it is nothing less than shocking to confirm his lawyer an an officer and director and to place him in charge of Debtor's management.

The Debtor's position is simple:

In the event of genuine wrongdoing by any director, manager or officer of the Debtor, such director, manager or officer should be removed whether by the Court, the Board of Directors or by both. However, where there was no real wrongdoing but merely a technical accusation which had no substantial merit to it, then a director, manager or officer who was experienced, and who operated the Debtor successfully, should not be removed.

The entire record shows that Weinstein and Fried did not act in violation of their trust but in the interests of their trust and for the protection of the Debtor.

Rehrig, Phillips & Robbins, Esqs., commenced raiding in order to purchase control of the Debtor's stock so that

Rehrig, who was a substantial tenant of the Debtor, would get a preferential lease [R. 296, 459-60].

It was after Rehrig and Phillips bought the stock of the Debtor and attempted to buy more, to gain control, that Weinstein and Fried advised the stockholders not to sell, and in some instances, purchased stock themselves. This was not done for their own pecuniary benefit or immorally [R. 463]. Even the District Court realized that fact when it stated that for equitable reasons Weinstein and Fried would not be compelled to reimburse either compensation or expenses received by them theretofore [R. 498].

The purpose of Chapter X is to effect a rehabilitation of the Corporate Debtor so as to preserve the going concern value of their property and to do so in an efficient and expeditious manner.

A reading of the Senate report (1916 on H. R. 8046, 75th Congress, Third Session, 1938), clearly envisions the maintenance of the going concern value of the Debtor.

From the evidence elicited, it clearly appears that the existing management has operated the Debtor successfully. There has been no determination by the District Court that there was any malfeasance or misfeasance damaging to the Debtor. The sole grounds for the dismissal of Weinstein and Fried by the District Court was that Weinstein and Fried violated Section 249 of the Bankruptcy Act [R. 249, 2574. The Court of Appeals found no wrong doing [R. 582].

It is submitted that the Court of Appeals was correct in determining that §249 of the Bankruptcy Act did not apply to respondents Fried and Weinstein. In addition, the spirit of §249 has not been violated so as to warrant the removal of successful management and in its place

appoint a management adverse to the interests of the Debtor.

Such a result, if accomplished, would be in direct violation of the very essence and purpose of bankruptcy reorganizations, which is to conserve the Debtor's assets and do what is necessary in the best interests of the Debtor.

Conclusion

1. In the interests of the Debtor, Weinstein and Fried should not be removed from management.

2. The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

ALEX L. ROSEN,
Counsel for Respondent-Debtor.

MARVIN N. ROSEN,
On Brief.

APPENDIX A

Payments by Nazareth Investors to John Malakoff From March 14, 1951 to March 25, 1953

(Compiled From Original Exhibits and Part of the Record)

1951	*Name*	*Claimants' Exhibit No.*	*Amount*
Mar. 14	Samet	2	$ 1,500
Apr. 2	G. Klein	5	2,000
Apr. 10	Samet	2	500
Apr. 10	Kanter	5	2,667
Apr. 10	Kanter *		1,333
Apr. 10	Mintz	(Dr's. K in Saul R. 547)	4,000
Apr. 10	D. Graveson		4,000
June 1	D. Clark	2	500
Aug. 1	B. Clark	2 & 3	3,000
Aug. 1	Masur	3	3,000
Aug. 1	B. Clark *		1,000
Aug. 14	F. Como *		4,000
Aug. 14	L. Como *		4,000
Aug. 25	Hull	3	2,400
Aug. 30	Bikales *		5,000
Sept. 1	J. Fried		2,000
Sept. 11	Treat	4	2,000
Sept. 12	Masur	4	400
Sept. 17	M. Klein	2	1,200
Sept. 18	Katie	5	2,000
Sept. 19	Weinstein	4	7,000
Sept. 19	Spielholtz	2	1,200
Sept. 20	Saul	4	3,000
Sept. 20	G. Klein	6	1,200
Sept. 29	D. Clark	2	1,125
Oct. 4	Hull	3	1,200
Oct. 18	Laupheimer	5	4,500
Oct. 18	Laupheimer *		500
Oct. 31	Bluestone	4	2,000
Nov. 2	Kane	6	1,000
Dec. 7	A. Fried	2	1,000
Dec. 20	Rosen	3	3,500
	Ida Margolis ***		9,000

* Payments made by cash.

*** Payment found by the Court of Appeals to have been made [R. 598].

1952	*Name*	*Claimants' Exhibit No.*	*Amount*
Jan. 4	Rosen	6	1,500
Jan. 7	A. Fried	3	1,000
Jan.	G. Klein		500
Jan. 21**	G. Klein	7	2,300
Mar. 5	Rosen	9	1,000
Mar. 11	D. Clark	2	200
Mar. 27	D. Clark	2	500
Apr. 10	G. Klein	8	2,000
July 25	H. Schwartz	3	2,000
July 30	D. Clark	2	550
Oct. 20	A. Fried	3	1,000
Nov. 10	Masur	5	500
Nov. 15	G. Klein	4, 2	6,000
Dec. 12	Laupheimer	4, 2	3,000
Dec. 14 & 15	Pollack	4	7,000
Dec. 16	Pollack	Cash	1,500
1953			
Jan. 14	G. Schwartz	4	2,000
Jan. 14	H. Schwartz	4	2,000
Jan. 25	Spielholtz	3	1,800
Feb. 2	F. Como	Cash	2,000
Feb. 2	L. Como	Cash	2,000
Feb. 17	Kaplan	2	1,000
Feb. 27	Bond	3	1,080
Mar. 4	P. Como	Cash	8,000
Mar. 16	Noire	3	5,000
Mar. 17	T. Schwartz	4	3,000
Mar. 20	H. Forman	7	6,000
Mar. 20	H. Forman	3	5,000
Mar. 25	Grossman	2	2,000
	William McK. Shongut ****		6,287
			160,362

** Total payments including this date $88,025.

**** Payment (cents excluded) found by the Court of Appeals to have been made [R. 598].

Payments by John Malakoff to Edward Malakoff, et al. for Purchase of the Market Property
[Saul. General: Examiner's J-R 537-9]

1951			
June	26	$ 3,750.00	
July	7	10,000.00	
Aug.	16	2,250.00	
Aug.	18	739.00	
Aug.	18	750.00	
Sept.	11	5,000.00	
Sept.	13	5,000.00	
Sept.	21	5,000.00	
Oct.	16	2,500.00	
Oct.	24	2,500.00	
Oct.	25	2,500.00	
Oct.	29	2,500.00	
Dec.	20	2,853.08	
1952			
Jan.	3	2,146.92	
Feb.	15	2,000.00	
			$ 49,489.00
Add: * Payment in November 1951 to Casper Simmers for Nazareth Improvements (Ex's BW, Saul Claim)			9,507.00
Total Payments by John Malakoff			$ 58,996.00

Recapitulation

Total Payments by Nazareth Investors to John Malakoff	$160,362.00
Total Payments by John Malakoff for Purchase of Market Property	58,996.00
Excess received by John Malakoff	$101,366.00

* Does not indicate $11,032.84 representing wind-storm insurance proceeds paid to the Philadelphia Group by the Debtor [#35—R. 57].

APPENDIX B

Text of Statutes Cited

Constitution of the United States, Article I, Section 8, Clause four:

SECTION 8. The Congress shall have power • • •

• • • To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States; • • •

Bankruptcy Act §1 (19); 11 U. S. C. §1 (19).

§1. Meaning of Words and Phrases.

• • • • •

(19) A person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts;

Bankruptcy Act §§2a, 2a(2), 2a(7), 2a(9), 2a(15), 2a(21), 2b; 11 U. S. C. §§11a, 11a(2), 11a(7), 11a(9), 11a(15), 11a(21), 11b.

§2. Creation of Courts of Bankruptcy and Their Jurisdiction. a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in

chambers, and during their respective terms, as they are now or may be hereafter held, to— * * *

(2) Allow claims, disallow claims, reconsider allowed or disallowed claims, and allow or disallow them against bankrupt estates; * * *

(7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, except as herein otherwise provided, and determine and liquidate all inchoate or vested interests of the bankrupt's spouse in the property of any estate whenever, under the applicable laws of the State, creditors are empowered to compel such spouse to accept a money satisfaction for such interest; and where in a controversy arising in a proceeding under this Act an adverse party does not interpose objection to the summary jurisdiction of the court of bankruptcy by answer or motion filed before the expiration of the time prescribed by law or rule of court or fixed or extended by order of court for the filing of an answer to the petition, motion or other pleading to which he is adverse, he shall be deemed to have consented to such jurisdiction; * * *

(9) Confirm or reject arrangements or plans proposed under this Act, set aside confirmations of arrangements or wage-earner plans and reinstate the proceedings and cases; * * *

(15) Make such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act: *Provided, however*, That an injunction to restrain a court may be issued by the judge only; * * *

(21) Require receivers or trustees appointed in proceedings not under this Act, assignees for the benefit of

creditors, and agents authorized to take possession of or to liquidate a person's property to deliver the property in their possession or under their control to the receiver or trustee appointed under this Act or, where an arrangement or a plan under this Act has been confirmed and such property has not prior thereto been delivered to a receiver or trustee appointed under this Act, to deliver such property to the debtor or other person entitled to such property according to the provisions of the arrangement or plan, and in all such cases to account to the court for the disposition by them of the property of such bankrupt or debtor. * * *

b. Nothing in this section contained shall be construed to deprive a court of bankruptcy of any power it would possess were certain specific powers not herein enumerated.

Bankruptcy Act §§67b, 67c, 67f; 11 U. S. C. §§107b, 107c, 107f:

b. The provisions of section 60 of this Act to the contrary notwithstanding, statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him. Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require

the liens to be perfected by the seizure of the property, they shall instead be perfected by filing notice thereof with the court.

e. Where not enforced by sale before the filing of a petition initiating a proceeding under this Act, and except where the estate of the bankrupt is solvent: (1) though valid against the trustee under subdivision b of this section, statutory liens, including liens for taxes or debts owing to the United States or to any State or any subdivision thereof, on personal property not accompanied by possession of such property, and liens, whether statutory or not, of distress for rent shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act and such liens for wages or for rent shall be restricted in the amount of their payment to the same extent as provided for wages and rent respectively in subdivision a of section 64 of this Act; and (2) the provisions of subdivision b of this section to the contrary notwithstanding, statutory liens created or recognized by the laws of any State for debts owing to any person, including any State or any subdivision thereof, on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of such property, shall not be valid against the trustee: * * *

f. (4) The court shall have summary jurisdiction of any proceedings to hear and determine the rights of any parties under this subdivision f and to hear and determine the sufficiency of the property of the estate for the full payment and discharge of all claims on account of all face-amount certificates sold by or on behalf of the debtor. Due notice of any hearing in such proceedings shall be given to every depositary and State agency which is a party in interest.'

Bankruptcy Act §§70a, 70c; 11 U. S. C. §§110a, 110c:

§ 70. Title to Property. a. The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located * * *

c. The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.

Bankruptcy Act §§111, 112, 130(1) 196; 11 U. S. C. §§511, 512, 530(1) 596:

SEC. 111. Where not inconsistent with the provisions of this chapter, the court in which a petition is filed shall, for the purposes of this chapter, have exclusive jurisdiction of the debtor and its property, wherever located.

SEC. 112. Prior to the approval of a petition, the jurisdiction, powers, and duties of the court and of its officers, where not inconsistent with the provisions of this

chapter, shall be the same as in a bankruptcy proceeding before adjudication.

SEC. 130. Every petition shall state—

(1) That the corporation is insolvent or unable to pay its debts as they mature;

SEC. 196. After the approval of the petition the judge shall prescribe the manner in which and fix a time within which the proofs of claim of creditors and of the interests of stockholders may be filed and allowed. Objections by any party in interest to the allowance of any such claims or interests shall be heard and summarily determined by the court.